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*In the United States Bankruptcy Court  
for the  
Southern District of Georgia  
Brunswick Division*

In the matter of:	)	
	)	
CONNER INSURANCE	)	Chapter 11 Case
AGENCY, INC. )	)	
	)	Number <u>93-20279</u>
<i>Debtor</i>	)	
	)	
	)	
	)	
THE TRAVELERS INDEMNITY	)	
COMPANY )	)	
	)	
<i>Movant</i>	)	
	)	
	)	
	)	
v.	)	
	)	
CONNER INSURANCE	)	
AGENCY, INC.	)	
	)	
<i>Respondent</i>	)	

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**MEMORANDUM AND ORDER**  
**ON MOTION FOR RELIEF FROM STAY**

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This matter comes before the Court on The Travelers Indemnity Company's Motion for Relief from the Automatic Stay. On September 15, 1994, a hearing was held to consider the Motion, after which the Court took the matter under advisement. Based upon the evidence adduced at the hearing, the record in the file and

applicable authorities, I make the following Findings of Fact and Conclusions of Law.

### FINDINGS OF FACT

Debtor filed a petition for relief under Chapter 11 of the Bankruptcy Code on April 30, 1993. In its bankruptcy schedules, Debtor revealed that The Travelers Indemnity Company ("Travelers") held a disputed claim against it. Travelers has not, however, filed a proof of claim in Debtor's case.

Prior to filing under Chapter 11, Debtor operated an insurance agency in southeast Georgia representing a number of commercial insurance carriers, including Travelers. Debtor's relationship with Travelers was governed by an agency contract entered into on November 1, 1987. Under the contract, Debtor was granted the right to represent Travelers and was required to timely remit to Travelers premiums collected on its insurance policies. At some point in 1991 or 1992, the parties fell into dispute over Debtor's alleged failure to remit certain policy premiums to Travelers. They were apparently unable to resolve the dispute, and Travelers terminated its relationship with Debtor at some point in late 1991 or early 1992. Upon terminating the relationship, Travelers sold Debtor's book of Casualty-Property expirations and renewal rights to another agency in the area.

Debtor has remained in possession of the bankruptcy estate since filing its Chapter 11 petition as a debtor-in-possession, but has ceased its operations as an insurance agency. On August 27, 1993, Debtor filed its Disclosure Statement and Plan of Reorganization. The Plan proposes to liquidate all of Debtor's tangible assets and potential causes of actions over a period of five years. Although the Plan has yet to be confirmed, all

of Debtor's tangible assets have been liquidated. The only asset remaining in Debtor's estate is a lawsuit that Debtor initiated against Travellers on March 8, 1994, in the District Court for the Southern District of Georgia.

Debtor alleges in the lawsuit that Travelers breached the agency contract by failing to liquidate Debtor's book of business in a commercially reasonable manner and by failing to account for all sums received from the liquidation. On June 8, 1994, Travelers filed an answer to Debtor's complaint, as well as a counterclaim alleging fraudulent misappropriation of premium income, conversion, breach of contract and breach of fiduciary duty.

On August 8, 1994, Travelers filed the instant motion seeking relief from the automatic stay to pursue its counterclaim against Debtor in the District Court. In support of the motion, Travelers contends that, even though it chose not to file a proof of claim in Debtor's bankruptcy case, it nevertheless possesses a right of setoff under Georgia law that is preserved by section 553(a) of the Bankruptcy Code. Thus, according to Travelers, the automatic stay should be lifted to allow it to assert its counterclaim and set off damages caused by Conner's misconduct, including uncollected and misappropriated premiums, interest, costs, punitive damages, and attorney's fees, against any amount that might be awarded to Debtor on its claim for breach of contract.

Debtor makes several arguments in opposition to the motion. First, Debtor contends that, under Georgia law, a claim that exists *ex-delicto* cannot be used to offset a claim arising *ex-contractu*, and as a result, Travelers does not have a right to offset the tort claims

in its counterclaim against Debtor's complaint for breach of contract. Second, Debtor contends that, even if Travelers does possess a valid right of setoff under state law, its failure to file a proof of claim bars it from asserting that right under the exception contained in section 553(a)(1). Finally, Debtor contends that, even if Travellers is entitled to setoff under section 553(a), relief from the automatic stay is inappropriate under the three-pronged test previously adopted by this court when considering a motion seeking relief from the stay to pursue a claim against a debtor in a forum other than the bankruptcy court where the debtor's bankruptcy case is pending.<sup>1</sup>

### CONCLUSIONS OF LAW

Section 553(a), in relevant part, provides:

Except as otherwise provided in this section and in sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case, except to the extent that--

(1) the claim of such creditor against the debtor is disallowed other than under section 502(b)(3) of this title .

...

11 U.S.C. §553(a). "Setoff is an established creditor's right to cancel out mutual debts against one another in full or in part. The purpose of setoff is to avoid 'the absurdity of making A pay B when B owes A.'" In re Patterson, 967 F.2d 505, 508 (11th Cir. 1992) (*quoting Studley v.*

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<sup>1</sup> See Matter of Classic Auto Painting & Bodyworks, Inc., Ch. 11 Case No. 93-40730, Memorandum and Order on Motion for Relief From Stay (Bankr. S.D.Ga. December 15, 1993) (Davis, J.). See also Matter of Video Cassette Games, Inc., 108 B.R. 347, 349 (Bankr.N.D.Ga. 1989); In re Pro Football Weekly, Inc., 60 B.R. 824, 826 (N.D.Ill. 1986); In re Bock Laundry Machine Co., 37 B.R. 564, 566 (Bankr.N.D. Ohio 1984).

Boilston Nat. Bank of Boston, 229 U.S. 523, 528, 33 S.Ct. 806, 808, 57 L.Ed. 1313 (1913)).

There are two things to note about section 553(a). First, section 553(a) does not create a right of setoff in bankruptcy. It instead merely preserves such a right when it otherwise exists independently under state or federal law. In re Orlinski, 140 B.R. 600, 602 (Bankr. S.D.Ga. 1991) (Dalis, J.). Second, section 553(a) is, by its own terms, subject to the automatic stay of section 362.<sup>2</sup> Thus, even when a creditor holds a valid right of setoff under section 553(a), relief from the automatic stay must be obtained before the creditor can exercise that right. Patterson, 967 F.2d at 511-12.

To establish a right of setoff under section 553(a), a creditor must demonstrate the following elements:

- 1) That an independent right of setoff exists under either federal or state law;
- 2) That both the debt that the debtor owes to the creditor and the debt that the creditor owes to the debtor arose prior to bankruptcy; and
- 3) That the debts are mutual; that is, the entity that owes a debt is the same entity that is owed a debt; and
- 4) That none of the exceptions contained in sections 553(a)(1) through (a)(3) apply.<sup>3</sup>

Here, the parties do not dispute that the debts in question arose prior to Debtor's bankruptcy or that the debts are mutual. Their dispute centers around whether Travelers possesses a right to setoff under Georgia law and whether the exception contained in section 553(a)(1) applies.

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<sup>2</sup> See 11 U.S.C. §§ 362(a)(7), 553(a); Orlinski, 140 B.R. at 602.

<sup>3</sup> See Patterson, 967 F.2d at 509; In re Orlinski, 140 B.R. 600, 602 (Bankr. S.D.Ga. 1991); In re Pyramid Industries, Inc., 170 B.R. 974, 982 (Bankr. N.D.Ill. 1994); In re Selma Apparel Corp., 155 B.R. 241, 243 (Bankr. S.D.Ala. 1992).

Turning first to the question of Traveler's right to setoff, Debtor is correct in its assertion that the general rule under Georgia law is that "a cause of action *ex delicto* cannot be set-off against an action *ex contractu*, and vice versa." Heard v. Melin, 107 Ga.App. 772, 131 S.E.2d 131, 132 (1963) (citations omitted). An exception to this rule arises, however, when there are equitable circumstances present, and the insolvency of the party against whom setoff is asserted has been identified as one such equitable circumstance. Id. There is little question that Debtor is insolvent. First, it was revealed at a status hearing held on June 13, 1994, that, under Debtor's Plan, payment of a dividend to Debtor's tax claimants and general unsecured claimants is completely dependent upon the recovery obtained in the lawsuit against Travelers. Moreover, the bankruptcy schedules that Debtor filed with its petition indicate that its liabilities exceed its assets by more than \$50,000.00. Accordingly, I find that Debtor is insolvent, and consequently, that Travelers possesses, for the purposes of this Motion only, the right under Georgia law to offset its tort claims against Debtor's contract claims.

The remaining question, then, is whether section 553(a)(1) is applicable to this case. This provision creates an exception to the right of setoff under section 553(a) when a creditor has had its claim disallowed under any provision except section 502(b)(3). Debtor contends that Travelers' failure to file a proof of claim in the case triggers this exception, while Travelers argues that its failure to file a claim is not equivalent to having its claim disallowed. I agree with Travelers. A number of courts have held that the filing of a proof of claim is not

a prerequisite to a right of setoff under section 553(a).<sup>4</sup> As the bankruptcy court in the Northern District of Georgia observed:

"Section 553(a) does not contain a requirement that a creditor seeking to exercise a setoff must first file a proof of claim." . . . The use of the term "disallowed" [in section 553(a)(1)] suggests that the merits of the creditor's claim would be reached. In the case sub judice, the Court has not adjudicated the validity of the claim; it has only found that it is time-barred from participation in the bankruptcy estate. Whether Movants have a valid right of setoff against any claim the Debtor may have against them is not before the Court. The stay should be lifted to allow Movants to assert their counterclaim against the Debtor in the District Court.<sup>5</sup>

Similarly, this court has not adjudicated the merits of Travelers' claim against Debtor. I thus conclude that the exception of section 553(a)(1) is inapplicable to this case. Travelers has, therefore, made a prima facie showing that it possesses a valid right of setoff under section 553(a), thereby shifting to Debtor the burden of proving that relief from the automatic stay is inappropriate in this case.<sup>6</sup> Debtor contends in this regard that allowing Travelers to exercise its right of setoff through the prosecution of its counterclaim in the District Court will impose significant expenses upon Debtor and greatly prejudice the bankruptcy estate. I find this argument unavailing. Perhaps the most important consideration

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<sup>4</sup> See e.g., In re Davidovich, 901 F.2d 1533, 1539 (10th Cir. 1990); In re G.S. Omni Corp., 835 F.2d 1317 (10th Cir. 1987); In re Selma Apparel Corp., 155 B.R. 241, 244 (Bankr. S.D.Ala. 1992); Matter of Central Equip. & Service Co., Inc., 61 B.R. 986, 988 (Bankr. N.D.Ga. 1986); In re Ford, 35 B.R. 277, 279 (Bankr. N.D. Ga. 1983). Clearly the counterclaim can result in no affirmative recovery against debtor. B.R. 3003(c)(2). However, up to the amount of any recovery debtor may be entitled to, defendant is entitled to assert its set off right.

<sup>5</sup> Matter of Central Equip. & Service Co., Inc., 61 B.R. at 988 (*quoting* Waldschmidt v. Columbia Gulf Transmission Co. (In re Fulghum Constr. Corp.), 23 B.R. 147 (Bankr. M.D.Tenn. 1982)).

<sup>6</sup> As with all motions for relief from stay, Debtor bears the ultimate burden of proof on all issues except as to whether there is equity in property. See 11 U.S.C. § 362(g)(2); Orlinski, 140 B.R. at 602.

in assessing whether relief from the stay is warranted, is the fact that Debtor initiated the litigation currently pending in the District Court. It is not as if Travelers is before this court seeking relief from the stay to pursue unrelated litigation against Debtor in some distant forum. To the contrary, Travelers seeks only pursue the counterclaim to the extent necessary to offset any liability imposed upon it in a lawsuit that Debtor initiated. As a court of equity I am not inclined to allow a debtor to initiate a lawsuit against a party and then use the shield of bankruptcy to prevent that party from having the opportunity to fully defend itself and minimize its liability. Accordingly, I find that there is sufficient cause to lift the automatic stay to allow Travelers to pursue its counterclaim against Debtor in District Court.

#### O R D E R

Pursuant to the foregoing Findings of Fact and Conclusions of Law, IT IS THE ORDER OF THIS COURT that The Travelers Indemnity Company's Motion for Relief from Stay be GRANTED to allow it to assert and prosecute its counterclaim against Debtor, Conner Insurance Agency, Inc., in the action pending in the United States District Court for the Southern District of Georgia, styled as Conner Insurance Agency, Inc. v. The Travelers Indemnity Company, Civ. Action No. CV294-29 (S.D.Ga, Brunswick Division), for compensatory damages only.

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Lamar W. Davis, Jr.  
United States Bankruptcy Judge

Dated at Savannah, Georgia



This \_\_\_\_ day of November, 1994.